BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP
CHAIRMAN
GARY PIERCE
COMMISSIONER
BRENDA BURNS
COMMISSIONER
BOB BURNS
COMMISSIONER
SUSAN BITTER SMITH
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF ARIZONA WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND FOR ADJUSTMENTS TO ITS RATES AND CHARGES FOR UTILITY SERVICE FURNISHED BY ITS NORTHERN GROUP AND FOR CERTAIN RELATED APPROVALS.	Docket No. W-01445A-12-0348

RUCO'S OPENING BRIEF

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INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits this Brief in response to Settlement ("Settlement") reached between the Arizona Water Company's ("Arizona Water" or "AWC" or the Company") and the Arizona Corporation Commission Staff's ("Staff"). The Settlement requests that the Arizona Corporation Commission ("Commission") authorize a rate increase of $2,240,329 for AWC's Northern Group[1].

RUCO recommends the Commission reject the Settlement as proposed. RUCO takes issue with the following aspects of the Settlement - the implementation of a System Improvement Surcharge ("SIB"), the proposed declining usage adjustment, and the recommended 10 percent return on equity. Adjusting for these three issues as will be further explained results in a proposed revenue increase of $1,691,803.

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1. THE COMMISSION SHOULD REJECT THE SIB. THE SIB SHIFTS RISK FROM THE COMPANY TO THE RATEPAYER WITHOUT ADEQUATE FINANCIAL CONSIDERATION TO THE RATEPAYER

RUCO opposes the SIB mechanism because ratepayers are not adequately compensated for the additional risk associated with the SIB and because it is illegal[2]. The SIB mechanism reduces regulatory lag in favor of AWC because the Company will not have to wait until new rates go into effect to recover a return on SIB eligible plant or the depreciation expense associated with it. 0310 RUCO-12 at 10[3]. However, any actual cost savings, such as lower operating and maintenance expenses, attributable to the new plant are not truly captured by the mechanism and are not adequately flowed through to ratepayers. Id. The reason for

[1] For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The transcript volume number will identify references to the transcript. A-1 at 1.

[2] Not surprisingly, many of the arguments here are taken from RUCO's Brief filed in the Phase II Docket (11-0310) but are worth repeating.

the mismatch is the SIB filings will consider eligible plant placed in service after the time period considered in the rate case. 0310 Transcript at 258. Hence, the operating expenses associated with the SIB plant as well as all of the other rate case elements normally considered in a rate case will not be considered. Id. This mismatch works against the ratepayer's interests and assures that ratepayers will not pay their actual cost of service and will more than likely pay more over time.

Ratepayers will be paying for the recovery of and return on routine plant placed into ratebase in between rate cases that the ratepayer would not otherwise pay until the next rate case. To the extent the ratepayer receives a benefit through the efficiency credit on the return associated with the SIB related plant that paltry benefit is only available until the next rate case filing when the relevant plant is rolled into the ratebase and subject to the COE awarded in the next rate case. 0310 Transcript at 457.

While no one will know the true extent of the efficiency credit until the Company actually makes its SIB filing, the Company's Schedule A-3 provides a good idea. Schedule A-3 shows a hypothetical calculation of the overall SIB revenue requirement for the Superstition Division in the Eastern Division. 0310 A-3 at 1. With an overall SIB revenue requirement of $292,300, the overall efficiency credit would be $14,615 (5 percent). 0310 A-3. This hypothetical exemplifies the imbalance between the ratepayer's benefit and the shareholder's benefit.

Of course, in this case, when considering the shareholder benefits, the Commission should not limit its consideration to just the SIB. The 10 percent Cost of Equity ("COE") is 90 basis points above what Staff recommended in its direct case (9.1 percent) and 125 basis points above what RUCO recommended in its direct case (8.75 percent). S-3 at 34, RUCO-8

[3] As per the ALJ's suggestions, references to exhibits incorporated in this record from Docket W-01445A-11-0310 will be preceded with or identified with the Docket Number 0310.

at 5. The COE is just an additional shareholder benefit which further distorts the imbalance between the SIB financial benefit to the ratepayer and the SIB financial benefits to the shareholder.

Another argument advanced in support of the SIB that has a link to the financial benefit is that the SIB will promote rate gradualism. 0130 Transcript at 283 and 317. While the SIB may promote rate gradualism, it comes at a cost. Ratepayers will pay higher rates because, among other things, the Company will earn a return on plant in between rate cases that it traditionally would not earn until the next rate case. Gradualism will also come at the expense of rate stability. 0130 Transcript at 306-307. Ratepayer's rates will change yearly as the result of each SIB filing. Id., A-1 at 5.

Each filing will also result in a rate increase. For reasons which will be addressed below, the SIB is not an adjustor. Ratepayers will see no actual cost savings that might be realized and will no longer benefit from the rate stability that exists under the present ratemaking procedure. Id. The Commission should reject the SIB.

a) THE SIB IS ILLEGAL IN ARIZONA

The SIB is a DSIC, and the same legal arguments made in the Eastern Division case apply here. See 0130 RUCO Opening Brief at 11-14 (Phase I), 0130 RUCO Reply Brief at 2-5, (Phase I). RUCO also incorporates the legal arguments made by Staff in its Eastern Division Opening Brief (0130 pps. 25-28, Phase I) and Reply Brief (0130 pps. 19-23, Phase I) to the extent they are consistent with RUCO's legal arguments. In all fairness to Staff, Staff did not foreclose the possibility that a DSIC mechanism could be constitutional. According to Staff, "…where exceptional circumstances exist, and a mechanism for a future rate adjustment is adopted in the context of a rate case as part of a utility's rate structure and if that mechanism meets the constitutional requirements that rate base is determined and the overall impact on

the rate of return prescribed, that mechanism will not violate the Arizona Constitution." Staff's Opening Brief (0130 Phase 1) at 26 citing *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533, 578 P.2d 612, 614 (App. 1978). While the signatories may contend that the SIB meets the Constitutional hurdles by such provisions as Schedule D in the Settlement, in truth, as will be more fully explained below, the SIB does not meet the Constitution's Fair Value Requirement.

Since the hearing in this matter concluded the Commission has decided the Eastern Division Case. The ROO in that matter was issued on May 28, 2013 and the Commission decided the matter on June 12, 2013. The final written Decision has not been docketed as of the writing of this Brief. However, it appears that the Commission has adopted the legal arguments set forth in the ROO.[4] RUCO has reviewed the Nodes ROO and does not agree with the legal arguments and conclusions. Given the timeliness of the Nodes ROO the following legal analysis is not meant to be exhaustive - RUCO will address the legal conclusions raised and will explain legally why it does not agree with the legal portion of the Nodes ROO.

The Nodes ROO concludes that the SIB mechanism requires a fair value finding. Nodes ROO at 50. The Nodes ROO further concludes that the SIB is an adjustment mechanism. ROO at 51. Finally, the Nodes ROO suggests that the SIB would still qualify as an exception to the fair value requirement under the "third exception" suggested in the *Scates* case. Nodes ROO at 44, 52-53. "In limited circumstances, the Commission may engage in ratemaking without ascertaining a utility's ratebase." *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. If in fact the SIB ascertains the Company's fair value ratebase, there should be no reason to consider the exceptions and surely no need to expand the exceptions to the constitutional fair value

requirement. The SIB does not ascertain the fair value rate base nor qualify as an exception under Arizona law. By way of order, RUCO will start with the exceptions first and then address the SIB's fair value rate base finding.

b) THE SIB IS NOT AN ADJUSTOR MECHANISM

At the risk of being repetitive it is important to establish what the SIB is and what it is not when considering its constitutionality. The Arizona Constitution protects consumers by generally requiring that the Commission only change a utility's rates in conjunction with making a finding of the fair value of the utility's property.[5] However, Arizona's courts recognize that, "in limited circumstances," the Commission may engage in rate making without ascertaining a utility's rate base.[6] One of those circumstances exists where the Commission has established an automatic adjustor mechanism. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616; *Residential Util. Consumer Office v. Arizona Corp. Comm'n ("Rio Verde")*, 199 Ariz. 588, 591 ¶ 11, 20 P.3d 1169, 1172. An automatic adjustor mechanism permits rates to adjust up or down "in relation to fluctuations in certain, narrowly defined, operating expenses." *Scates* at 535, 578 P.2d 616. An automatic adjustor permits a utility's rate of return to remain relatively constant despite fluctuations in the relevant expense. An automatic adjustor clause can only be implemented as part of a full rate hearing. *Rio Verde* at 592 ¶ 19, 20 P.3d 1173, *citing Scates* at 535, 578 P.2d 616.

The Commission has also defined adjustor mechanisms as applying to expenses that routinely fluctuate widely. In a prior decision in which it eliminated APS' fuel and power adjustor, the Commission stated:

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[4] The Phase II ROO for reference in this Brief will be referred to as the Nodes ROO.

[5] Arizona Constitution. Art. XV, § 14; *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P.781, 786 (1914); *Arizona Corporation Commission v. State ex rel. Woods*, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

> The principle justification for a fuel adjustor is volatility in fuel prices. A fuel adjustor allows the Commission to approve changes in rates for a utility in response to volatile changes in fuel or purchased power prices without having to conduct a rate case. (Decision No. 56450, page 6, April 13, 1989).

The Commission went on to discuss the undesirability of such adjustors because they can cause piecemeal regulation that is inefficient and undesirable. *Id*. at 8. *See also Scates* at 534, 578 P.2d 615.

In the subject case, the SIB clearly is not an adjustor mechanism – its purpose is not to account for fluctuating operating expenses. Its purpose is to allow for recovery of plant costs which increase rate base and thereby increase operating income. Unlike an adjustor, the SIB does not allow for rates to adjust "in relation to fluctuations in certain, narrowly defined, operating expenses." Moreover, the SIB only permits rates to adjust up, not down as the result of allowing for the SIB related plant recovery. 0130 RUCO -12 at 11.

Staff also recognized the *Scates* definition when it concluded that the Company's proposed DSIC was not an adjustor[7]. Staff Reply Brief at 21-22 (0130). While the SIB is different than the DSIC mechanism originally proposed by the Company in the Eastern Division case, there was no change made to it that automatically changed it from a non-adjustor mechanism to an adjustor mechanism. For the very same reasons, the SIB is not an adjustor.

Even if one could set aside the argument that Arizona's courts have only recognized adjustors for very limited operating expenses and not for operating income, the SIB mechanism still would not qualify as an adjustor because the justification for the mechanism is

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[6] *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 ¶11, 20 P.3d 1169, 1172 (App. 2001).

[7] There seems to be a difference of opinion in Staff on whether the Company's DSIC was an adjustor. 0130 Transcript at 297, Decision No. 73736 at 101, S-3 at 35 (Phase I). However, it appears that the legal section does not believe it was an adjustor.

not the volatility in the price of the plant. As explained, the concern here is the amount of the investment, and no case law parities the need for an adjustor mechanism with the magnitude of investment in plant. The SIB is not an adjustor mechanism nor should the exception be expanded in any manner to treat it as such.

c) THE COMPANY HAS NOT REQUESTED INTERIM RATES

The only other circumstance where the Commission may engage in rate making without ascertaining a utility's rate base involves requests for interim rates.[8] The Commission's authority to establish interim rates is limited to circumstances in which 1) an emergency exists; 2) a bond is posted guaranteeing a refund if interim rates are higher than final rates determined by the Commission; and 3) the Commission undertakes to determine final rates after making a finding of fair value.[9] The Arizona Attorney General has opined that an emergency exists when "sudden change brings hardship to a company, when a company is insolvent, or when the condition of the company is such that its ability to maintain service pending a formal rate determination is in serious doubt."[10]

The Company has not asserted an emergency nor requested interim rates. Regardless, and perhaps the reason why the Company has not asserted an emergency, is because the Company would not meet the legal criteria – there is no evidence of a sudden change that has brought hardship,[11] no insolvency issue, or evidence that the Company has an inability to maintain service in the interim or long term for that matter.

[8] *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-35, 578 P.2d 612, 614-16 (App. 1978).
[9] 199 Ariz. at 591, ¶12, citing Scates.
[10] 71-17 Opinion Arizona Attorney General at 50. (1971).
[11] The Company acknowledges that it has operated the Bisbee system for over 60 years and that much of the infrastructure is from the early 1900's. (0130 Tr. At 400-401)

d) THE SIB WOULD NOT QUALIFY UNDER THE 'THIRD EXCEPTION'

The Nodes ROO also lists what it refers to as a "third exception" contemplated by the Arizona Courts to the fair value requirement. Citing *Scates*, the ROO references the following:

> We do not need to decide in this case whether as a matter of law there must be a de novo compliance with all provisions of the order in connection with every increase in rates. The Commission here not only failed to require any such submissions, but also failed to make any examination whatsoever of the company's financial condition, and to make any determination of whether the increase would affect the utility's rate of return. There may well be exceptional situations in which the Commission may authorize partial rate increases without requiring entirely new submissions. We do not decide in this case, for example, whether the Commission could have referred to previous submissions with some updating or whether it could have accepted summary financial information.

(118 Ariz. 531, at 537, 578 P.2d 612, at 618) Nodes ROO at 44.

RUCO believes that an unabridged gap exists between a conclusion that a third exception exists and that the Arizona courts have determined that a third exception exists. RUCO is unaware of any case in Arizona that specifically identifies and sets forth the criteria for a third exception. Moreover, the Commission, if anything should be looking to narrow, not expand the exception to Arizona's Constitutional requirement that fair value be found. The provisions of Arizona's Constitution should be liberally construed to carry out the purposes for which they were adopted. *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984). Conversely, exceptions to a constitutional requirement should be narrowly construed. See *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that exceptions from a general policy embodied in the law should be strictly construed). Essentially, the Commission should not use the "emergency" exception or the adjustor mechanism exception liberally or create a "third exception" to set aside the rule of finding fair value when setting rates.

If a third exception does exist, the SIB in this case should not qualify. The SIB contemplates the inclusion of routine plant in between rate cases. There is hardly anything extraordinary about a utility that needs to replace aging infrastructure. In fact it is normal and usually the reason why a utility files a rate case. The SIB, at the very least will be support for any utility to seek extraordinary ratemaking to include routine plant for recovery in between rate cases. Staff's Director, Steve Olea provided insight on this important consideration in the Eastern Division case. Staff concluded in that the Company had not demonstrated extraordinary circumstances in the underlying case to justify the Company's proposal. 0130 S-3 at 35 (Phase I). When asked in Phase 2 what had changed, Mr. Olea responded the Commission's request that the parties were all directed to talk about the DSIC. 0130 Transcript at 301. In the hearing in this case, Mr. Olea again testified the same regarding the extraordinary circumstances. Transcript at 274. In Staff's view, a Commission directive to look at the DSIC constitutes an extraordinary circumstance. Staff's definition of "extraordinary" is even more murky and inconsistent when one considers that the Commission in the last company-wide rate case ordered the Company to do a DSIC study and report in its next rate case. Decision No. 73736 at 14-15. While it does not appear that Arizona's case law defines extraordinary or exceptional, it is doubtful that it would include the Commission's directive in this case. For example, *Scates* did define what was needed for interim rates – an emergency which is far more tangible than a mere directive. *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978).

Moreover, the Judge in the Phase 1 of the Eastern Division case warned that a DSIC can be viewed as a reward given a utility's own failure to maintain and improve its systems responsibly. 0130 Phase One ROO at 105. In the Eastern case, the Judge was worried about the Company's payment of shareholder dividends that could have been used to cover the

necessary infrastructure costs for some of its divisions. Id. Undoubtedly, that was one of the reasons which led the Judge to conclude it was not appropriate for the Commission to authorize a DSIC in that Decision. Id. In the present case we are still talking about the same Company having paid out, as its own witness admits, increasing dividends. Transcript at 100. RUCO believes that the same reasons exist in this case to deny the Company a DSIC.

e) THE SIB WILL INCREASE THE COMPANY'S FAIR VALUE RATE BASE WITHOUT ANY DETERMINATION OF FAIR VALUE

Having established that the SIB does not meet any of the criteria required by Arizona's Courts to side-step the Constitution's fair value requirement, the question then becomes whether or not the SIB complies with the Constitution's fair value requirement. First, it is important to recognize what the SIB is – it is a mechanism, not an adjustor mechanism, which will allow for the recovery of, and a return on routine plant in between rate cases, needed to address the Company's plant and improvement needs[12].

The SIB mechanism itself will be established as part of the pending rate case. Within 12 months of the date of the Commission's final decision, AWC will be able to file a request to implement the SIB surcharge. 0130 A-1 at 5, Section 4.2. The Company will be able to file for the SIB surcharge no more than five times between rate case decisions. 0130 A-1 at 5, Section 4.4. The Commission will ultimately consider and then may approve each surcharge filing. The Commission, however, will not be making a new FVRB finding as part of each surcharge filing in such a way as to make fair value meaningful. 0130 RUCO-12 at 13. As Staff noted concerning the DSIC, the SIB will do far more than simply pass on increasing costs to the Company - it will allow "…surcharges based on the cost of the new plant, effectively

[12] Again, its purpose is the same as the higher ROE that the Commission awarded in the underlying Eastern Division case. See Decision No. 73736 at 61.

increasing the fair value rate base without any determination by the Commission of what that fair value is." (See Staff Opening Brief at page 26 (0130)). The SIB suffers from the same constitutional deficiency effectively making it illegal in Arizona.

f) THE SETTLEMENT AND THE NODES ROO DO NOT CURE THE CONSTITUTIONAL INFIRMITIES OF THE SIB

Undoubtedly, the signatories will claim that the necessary constitutional safeguards are in place and the SIB passes constitutional scrutiny. RUCO challenges such a conclusion – the facts are the facts and the fact is that each SIB filing will not result in a meaningful FVRB finding nor will there be any finding by the Commission of what fair value is:

> "It is clear . . . that under our constitution as interpreted by this court, the commission is required to find the fair value of (the utility's) property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates. . . . While our constitution does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates. The reasonableness and justness of the rates must be related to this finding of fair value." Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

Section 7.17 of the SIB Settlement ("SIB Settlement") requires the filing of Schedule D which will show an analysis of the impact of the SIB plant on the fair value rate base, revenue, and the fair value rate of return as set forth in Decision No. 73736. 0130 A-1 at 9. This provision was obviously put in to satisfy *Scates,* but it does not go far enough:

> We do not need to decide in this case whether as a matter of law there must be a de novo compliance with all provisions of the order in connection with every increase in rates. The Commission here not only failed to require any such submissions, but also failed to make any examination whatsoever of the company's financial condition, and to make any determination of whether the increase would affect the utility's rate of return. There may well be exceptional situations in which the Commission may authorize partial rate increases without requiring entirely new submissions. We do not decide in this case, for example,

> whether the Commission could have referred to previous submissions with some updating or whether it could have accepted summary financial information. *We do hold that the Commission was without authority to increase the rate without any consideration of the overall impact of that rate increase upon the return of Mountain States, and without, as specifically required by our law, a determination of Mountain States' rate base.* Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 294 P.2d 378 (1956); Ariz.Const. art. 15, section 3; A.R.S. section 40-250. The Commission not only failed to make any findings to support its conclusion that the increases were just and reasonable, but it received no evidence upon which such findings could be based. *Scates* at 537, 578 P.2d 618. (Emphasis added).

While the SIB Schedule (D) may show the impact of the SIB plant on the rate base, the revenue and the fair value rate of return, the Commission will not, as required by law, make a meaningful finding of fair value and use that finding as a rate base for the purpose of establishing rates. 0130 R-12 at 13-15. In order to meet *Scates*, and hence fair value, the SIB filing would have to be on the scale of a rate case or at least a mini-type rate case where all of the rate case elements are considered. Schedule D shows the rate base (O.C.L.D.) but it only shows the capital costs and the depreciation expense associated with the plant additions. 0130 A-1, Schedule D, Transcript at 469. Hence, the SIB filings will only consider one piece – the SIB plant. 0130 Transcript at 258 and 469. It will not consider the operating expenses associated with that plant, the working capital, etc. Id. at 258, 292. The operating expenses that will be included in the rates that the Commission will approve after each SIB filing will be the operating expenses approved in Decision No. 73736 - operating expenses from a completely different period than the SIB plant under consideration. Id. In sum, there is no tie back to fair value and the SIB raises the specter of single issue ratemaking which was a concern of the *Scates* Court, the Commission's judges but apparently is no longer a concern of

Staff[13]. *Scates* at 534, 578 P.2d. 615, RUCO 5 at 5. **The SIB mechanism is single issue ratemaking, it is not fair value ratemaking - Schedule D renders fair value meaningless.**

The Nodes ROO adds an earnings test. Nodes ROO at 51. While an earnings test will provide the Commission with a measure of the Company's earnings at a designated point in time, it will not cure the constitutional fair value infirmity. The earnings test is an after-the-fact indicator of whether the Company's actual rate of return exceeded its authorized rate of return looking back over a designated time period. See Nodes ROO at 51. An earnings test is not relevant to an actual finding of fair value. There are other provisions of the SIB Settlement which will assure Commission oversight and approval of the SIB filings but nothing that requires a meaningful finding of fair value as required by Arizona's Constitution. The SIB is illegal and should be rejected.

g) THE SIB SETTLEMENT ITSELF IS TOO BROAD UNDER THE CIRCUMSTANCES OF THE EASTERN DIVISION CASE AND MANY OF ITS PROVISIONS ARE FLAWED

The SIB Settlement goes far beyond its original purpose. Moreover, many of its provisions and the Agreement as a whole raise more questions than answers. Admittingly, no Agreement is perfect. RUCO understands that, but the SIB Settlement should be tight and not subject to different interpretations.

RUCO takes issue with the following:

1) Section 3.3. The 5.00 percent efficiency credit is inadequate to compensate ratepayers for the shift in risk – it is paltry compared to the benefits the shareholders receive.

[13] Staff was concerned about the element of single issue ratemaking as concerns the DSIC in the underlying case. 0130 S-4 at 2-3.

2) Section 4.6 and 4.7. These provisions explain when the Company is required to file its next rate case and reset of the SIB surcharge. They do not, nor does the Settlement, explain what happens to the SIB after the next rate case. The circumstance after 2016 will be different than now and leaving such an important point open to interpretation is perilous.

3) Section 6 – Eligibility of SIB Plant. The Commission was originally concerned with the Company's water loss and looking at DSIC's designed to implement leak detection devices and make conservation-based repairs. The objective was to replace/repair/improve the infrastructure specifically to address the water loss. Decision No. 73736 at 15. The SIB expands the purpose to include almost every type of plant. For example, the SIB includes upgrades to fire mains which could clearly include upgrades whose sole purpose is for fire flow improvement. The Commission has made clear that such improvements do not warrant extraordinary ratemaking treatment. See for example Decision No. 70351 at 36. Staff claims it will be diligent in its review of the plant but Staff's personnel change as does the Company's personnel and who can say how such excess will be controlled in the future. This is only one example of how unintended plant could easily fit into the broad "categories" described in paragraph 6.4. The better question to ask is what plant is not eligible under the terms of the Agreement? Mr. Olea responded at hearing that plant not described in 6.4 would be ineligible. 0130 Transcript at 331. Staff's answer is of little to no value since 6.4 only describes categories (and a lot of them) and not specific types of plant.

RUCO's concern here, like most of the following concerns could easily be addressed with more detailed provisions. Instead, many of the provisions of the agreement are subject to different interpretations. On the issue of eligibility, it is worth noting that Section 6.3.1 lists as one of the eligibility criteria, water loss of a system that exceeds 10 percent. This specific provision, standing alone, could create perverse incentives. A Company with a water loss less than 10 percent could easily be motivated to ignore or neglect the issue or even take measures to worsen the situation to achieve eligibility. SIB approval would reward such impure conduct. This concern is not hollow – to be eligible all a utility needs to do is meet the standard – it then becomes the burden of Staff/RUCO and ultimately the Commission to ascertain whether the Companies motives are pure or not. It would not be difficult to hide such conduct – ascertaining one's intent is one of the most difficult things in the law to prove. Towards this end, a provision in this section which provides that eligibility is subject to the consideration of all of the facts and circumstances of any given case would tighten the agreement and perhaps provide a disincentive to questionable conduct.

A catch all provision would also cover the concerns Judge Harping raised in her ROO and Judge Nodes raised in the Eastern Group hearing concerning the Company's recent payout of dividends in view of its need for infrastructure improvement. 0130 ROO at 105. The Company complains of underearning and its inability to cover its expenses. When asked by Judge Nodes whether it would be appropriate for the Company

to account for all of its depreciation expense before being eligible for a SIB, the Company believed such a requirement would be unnecessary. The Company appears to believe that the issue is not accountability, but strictly cost recovery. 0130 Transcript at 116. The Company claims to have lost approximately $41 million since 1996. 0130 Transcript at 118. Nonetheless, as the Judge noted, the Company still managed to pay $5 million in dividends a year which over the same time period exceeded the $41 million it lost. Id. at 119. While Judge Harping would not go so far as accusing the Company of malfeasance, she did note that the Company was in a position to ameliorate its situation. The point should not be lost - such circumstances should be considered when contemplating the SIB.

It is not entirely clear under Section 6 of the SIB Settlement that the history of company, its past financial circumstances, etc. are considerations for eligibility. Section 6.3.3 provides for the engineering, operational and financial justification for SIB eligibility, but the language, again is subject to interpretation.

4) Section 6.5. This provision provides for the procedure after the Company makes its request to modify or add SIB projects. Staff and RUCO will then have 30 days to object. 0130 A-1 at 8. If either objects, it is left unstated what will happen and subject to interpretation as was made obvious in the hearing. 0130 Transcript at 250-252, 286-287.

5) Section 7.17. This provision provides for an impact statement. It appears to be a provision put in place in an effort to meet the *Scates* requirements.

But as discussed above, it falls short of meeting *Scates* and the fair value requirement.

6) RUCO is concerned that the SIB projects could generate revenues by serving new customers. It is not made clear in the provisions of the Agreement that the SIB plant is to be non-revenue producing. To some degree RUCO's concern is diminished by the verbiage in Table 1 which indicates for each project that it is not being constructed to serve new customers. 0130 A-1, Exhibit A. Again, it is not spelled out in the Settlement's provisions and it is easy to see how this point could get lost or just amount to lip service as time goes by.

h) THE SIB IS NOT IN THE PUBLIC INTEREST

There are numerous reasons why RUCO does not believe the SIB is in the public interest. The SIB is illegal in Arizona, and hence not in the public interest. The SIB does not adequately compensate ratepayers for the shift in risk that will result – a five percent efficiency credit is a paltry quid pro quo - all one needs to do is look at 0130 Exhibit A-3 to put it into perspective. The Commission has made it clear in adopting Commissioner Pierce's Amendment #3 to the Nodes ROO that it does not believe that there is a relationship between the SIB and the ROE. RUCO respectfully disagrees and believes that not considering a downward adjustment to the Company's ROE to reflect the lower risk, given the inadequacy of the efficiency adjustment is not in the public interest. Judge Harping in the Eastern case and Judge Rodda in the Rio Rico[14] case seem to have a different opinion than the Commissioners'

[14] Judge Rodda noted that bifurcation as proposed by the Company in that case "hinders the ability of parties to argue their positions as to whether and how the DSIC affects the cost of capital and/or operating expenses, and could adversely affect the Commission's ability to set just and reasonable rates." Clearly, Judge Rodda was at least willing to consider that a relationship between the DSIC and ROE exists. See Procedural Order dated March 20, 2013, Docket No.WS-02676A-12-0196, at pp. 5-6.

on the relationship between a DSIC and the ROE – such conflict on such an important issue is not good. Perhaps even more compelling is the fact that the Commission addressed the infrastructure needs in the Eastern case by awarding a higher ROE. The Commission then went ahead and approved the SIB in the Eastern case without reducing the ROE in that case. In the Eastern case, the Commission, contrary to what Judge Nodes recommended, approved two mechanisms to address the same issue. Likewise, in the present case, it will appear to be doing the same thing, given the 10 percent COE proposed in the Settlement and the recommended lower costs of equity that Staff and RUCO proposed in their direct cases. Under the Settlement, the Company gets an SIB and a higher ROE, the ratepayer gets a paltry 5 percent efficiency credit. RUCO asks how that is in the public interest.

Approval of the SIB here will continue a bad precedent - why would a Company not ask for both a higher ROE and a SIB to address its water loss related infrastructure needs in the future? How will the Commission distinguish any future case and not allow for the approval of two mechanisms to address the same thing? Seriously, can a reasonable argument be made that it is fair to the ratepayer for the Commission to approve two mechanisms to address the same thing?

The fact that the Commission is the "extraordinary" catalyst that now makes it necessary to use extraordinary ratemaking is not in the public interest. In fact, its potential future ramifications are nothing short of just plain scary. The SIB Settlement itself is loaded with provisions that are subject to different interpretations and omissions on important points as explained above. The Commission need only go back to the TEP Settlement in 1999 and how the different interpretations of that settlement became the central focus of TEP's last rate case. See Docket No. E-01933A-07-0472. The Commission should be wary of repeating that situation – such confusion is surely not in the public interest.

There are other reasons why the SIB is not in the public interest - but the point is made. RUCO believes that the SIB is not in the public interest.

2. THE COMMISSION SHOULD REJECT THE DECLINING USAGE ADJUSTMENT

Like the SIB, the result of the declining usage adjustment is to shift risk to the ratepayer. The point of the declining usage adjustment is to make the Company whole for declines in projected water consumption. The adjustment will allow for the recovery of forecasted shortfalls of revenue through a rate design calculated with usage-adjusted billing determinants. RUCO-5 at 17. In the event the Company's forecasts are off and the anticipated declines in consumption do not occur, the Company will over collect its authorized level of revenue, and could see an unwarranted increase in operating income. Id. at 18. In fact, RUCO has calculated in this case, that should declining usage trends flatten out, the Northern Group, would realize an additional $419,644 annually in operating revenue over the $2,240,313 million in operating revenue produced by the adjusted test year billing determinants adopted in the Settlement Agreement. Id. at 21. Interestingly, Staff, whose role is to balance the interests of the ratepayers and shareholders, no longer appears to be the least bit concerned that the Company's forecasts could be off at a significant cost to the ratepayer. Transcript at 299-300. Given the history of this adjustment and the circumstances of this case, the Commission should reject this adjustment.

This case is not the first time the Company has proposed this type of adjustment. In the Company's district wide rate case, the Company proposed the "Northern Group Conservation Adjustment." Decision No. 71845 at 68. While that adjustment worked different than the declining usage adjustment in this case, its purpose was to "… recognize the downward impact on revenues that the Company claims will be experienced by the imposition of tiered rats for

the systems in that Group." Id. Staff asserted that the Company's proposal was speculative and should have been denied. Id. at 69. The Commission ultimately denied the Company's proposal. Id.

Thereafter, in the Company's Western Group Case (Docket No. W-01445A-10-0517), the parties arrived at a Settlement that did not include a declining usage adjustment. Most recently, in Eastern Group case the issue was squarely addressed. Similar to the subject case, the Company proposed an adjustment for declining use. Decision No. 73736 at 66. RUCO opposed the adjustment for the same reasons it opposes the present adjustment. Id. at 68. Staff also opposed the adjustment (at least as it applied to the residential customers) as it found Mr. Reiker's "… estimates of change in use per customer to be unstable, to vary with the time frame for analysis, and thus not to be known and measurable. Id. at 68-69 (Ex. S-7 at 5 (0130))."[15] The Commission, in rejecting the proposed declining use adjustment concluded:

> Because AWC chose to make its adjustments to billing determinants rather than through revenues and expenses, we cannot be confident that the appropriate associated reductions to future operating costs, as reflected in the graph in Mr. Reiker's direct testimony, have also been made. AWC's adjustment methodology also makes it difficult to identify the projected annual impact of the normalization adjustments (as opposed to the impact of the proposed changes in rate design), although it appears that the normalization adjustment would impact annual revenue in an amount between $155,438.91 and $446,738.55 at AWC's proposed rates.
>
> It is possible that, with more complete and transparent information as to the normalization adjustment methodology and its impacts, the Commission might find such an adjustment to be appropriate in the future. The Commission understands that a consistent pattern of declining usage, and the diminished revenues that follow, could jeopardize AWC's ability to recover its cost of service, which is contrary to the best interests of AWC, AWC's customers, and the Commission. However, the Commission will not approve such an adjustment without first being confident that the changes in usage are known and measurable, that any corresponding changes in costs have

[15] Staff did accept a declining usage adjustment for the commercial customers in the Superstition Division. Id. at 69.

> been factored into the normalization calculation so as to avoid mismatches and over-recovery, and that the Commission is aware of the actual impacts of the adjustment on proposed rates.

Decision No. 73736 at 70-71. Decision No 73736 was docketed February 20, 2013 – several months ago. The Commission did not mince words – the Commission made clear what would be required to approve such an adjustment.

The Director of Staff, Steve Olea, when asked whether he had considered the Commission's directives in the current case inferred that he had not. Transcript at 283**.** Mr. Olea could not explain how the Commission could be confident that the appropriate associated reductions to future operating costs were made under the proposal nor could he explain the projected annual impact of the normalization adjustments. Id at 283-284. There is no evidence which addresses the Commission's recent directive on this issue – in fact, the evidence indicates that the changes in usage will not be known and measurable, there will be no corresponding changes in costs factored into the normalization calculation so as to avoid mismatches and over-recovery, and that the Commission cannot be assured of actual impacts of the adjustment on proposed rates. Transcript at 283-285. The old baseball adage – "three strikes and you are out" should be applied, and the Commission should reject the declining usage proposal.

Staff's change of position on this is further puzzling in light of its position in its direct case. There, Staff's witness, Jeffrey Michlik, recommended that the Commission reject the Company's declining usage proposal. Mr. Michlik noted that the "normalization" adjustments "… can result in higher rates because revenue requirement targets will be spread over fewer billing determinants." S-1 at 4. At the same time, Mr. Michlik recommended rejection of all of the Company's

> "…normalization adjustments based on the Company's estimates of trends in use per customer. The adjustments are based on slope coefficients determined by statistical regression analysis. The coefficients vary significantly when the analysis is conducted over varying time frames (e.g., ten vs. five years). Consequently the adjustment cannot be known and measurable."

S-1 at 4. Mr. Olea confirmed that the Settlement proposal had not addressed Mr. Michlik's concerns and that it could result in higher rates because of revenue requirement targets will be spread over fewer billing determinants. Transcript at 278. In truth, there is no way a declining usage adjustment will not result in higher rates if usage levels decline - so neither Mr. Olea's testimony nor Mr. Michlik's testimony comes as a surprise. Mr. Michlik's testimony is at least consistent with Mr. Olea's in that no attempt had been made to comply with the Commission's Eastern Group Decision requirements for an acceptable adjustment.

Given these facts, the obvious question is why Staff would compromise this one away. With the SIB, an argument can be made that there is some benefit, albeit small, to the ratepayer. But a declining usage adjustment is counter to the ratepayer's interests in all regards – it is a one sided adjustment – purely for the shareholder. There is always comfort in a lower cost of equity to address the obvious imbalance favoring the shareholder, but in the Settlement Staff is recommending a COE that is 90 basis point higher than its direct case – another coup for the shareholder.

The only "logical" explanation is that Staff favors the shareholder over the ratepayer in this case. When asked if there are situations where Staff would favor one group over the other, Mr. Olea admitted there are circumstances. Transcript at 287. Mr. Olea explained that an example would be the situation where it looks like Staff's position will not get adopted by the Commission. Id. Regardless of the reasons why, given the terms of the Settlement, it appears that Staff favors the shareholders over the ratepayers in this case.

Both Staff and the Company justify the adjustment based on their guess of future usage – which is nothing more than a guess. If Staff and the Company are wrong, the Company gets a windfall, ratepayers lose and there is no consideration to the ratepayer for the additional risk. The Settlement proposes this adjustment despite no evidence that the declining usage the Company has experienced in the past is the result of the Commission's inclining block tiered rate design. RUCO-6 at 2. Declining sales could be related to the poor economy. Id. The notion that usage will continue to decline is also inconsistent with the drying pattern recently experienced. A-4 at 9. Even the Company admits that the drying patterns relation to usage is "…troubling considering the historical correlation between water consumption and climate, which normally would mean an *increase* in per capita water sales during this period." Id.

The Company at hearing presented an exhibit showing a summary of per capita sales for the Navajo and Verde Valley districts. A-16. Admittingly, the graphs showing the usage are declining slightly, but if anything, the linear line for both districts appear to be leveling. Id. The evidence in this case is at best questionable to support the declining use estimate, and ratepayers should not be subject to the risk if Staff and Company is wrong.

3. THE PROPOSED COST OF EQUITY IN THIS CASE IS TO HIGH UNDER THE CIRCUMSTANCES OF THIS CASE

For the most part, RUCO has touched upon the cost of capital and the various arguments associated with it throughout this brief. As a sanity check, however, it is worth taking a look at the Settlement agreed to in the recent Western Group case. There, Staff, in justifying its support for that Settlement noted that the Settlement was fair because it adopted a 10 percent cost of equity which Staff had recommended in its direct case and did not implement a DSIC. Decision No. 73144 at 38-39. The Settlement also did not contain a declining usage adjustment. By comparison, the present Settlement includes a DSIC

mechanism, a declining usage adjustment and a 90 basis point COE bump from Staff's direct case. The Settlement in this case is not fair and balanced and should be rejected.

4. THE SETTLEMENT IS NOT IN THE PUBLIC INTEREST

The approval of the Settlement is not in the public interest if it includes the SIB, the declining usage adjustment and the overstated COE. The SIB is illegal in Arizona, and hence not in the public interest. The SIB does not adequately compensate ratepayers for the shift in risk that will result – a five percent efficiency credit is a paltry quid pro quo - all one needs to do is look at Exhibit A-3 (0130) to put it into perspective. In the Eastern Group case, the Commission has approved two mechanisms to address the infrastructure issue – the SIB and the higher ROE. If the Commission approves the SIB here, like in the Eastern case, the Company will get a SIB and a higher ROE than what Staff and/or RUCO originally recommended. RUCO asks how that is in the public interest.

The approval of the Settlement in this case would also continue bad precedent[16] - why would a Company not ask for both a higher ROE and a SIB to address its water loss related infrastructure needs in the future? How will the Commission distinguish any future case and not allow for the approval of two mechanisms to address the same thing? Seriously, can a reasonable argument be made that it is fair to the ratepayer for the Commission to approve two mechanisms to address the same thing? Approval of the SIB in this case under these circumstances will no doubt continue the Commission down a slippery slope.

The fact that the Commission is the "extraordinary" catalyst that now makes it necessary to use extraordinary ratemaking is not in the public interest. In fact, its potential future ramifications are nothing short of just plain scary. The Settlement itself is loaded with provisions that are subject to different interpretations and omissions on important points as

explained above. The Commission need only go back to the TEP Settlement in 1999 and how the different interpretations of that settlement became the central focus of TEP's last rate case. See Docket No. E-01933A-07-0472. The Commission should be wary of repeating that situation – such confusion is surely not in the public interest.

The declining usage adjustment is not in the public interest. It is based simply on a guess and if that guess is wrong ratepayers will pay and the Company will likely earn a windfall. Moreover, and perhaps even more important, the Commission established criteria in the months old Eastern case that must be met before it would approve such an adjustment. Decision No. 73736 at 70-71. That criteria has not been met - aside from the obvious negative connotations associated with approving an adjustment that does not meet the criteria the Commission set less than six months ago, such approval could affect the integrity of the Commission's decisions going forward – why would anyone have any faith in a Commission decision if the Commission does not require compliance with its own judgment? The Commission should not approve the declining usage adjustment as it would be contrary to the public interest.

5. CONCLUSION

For all of the above reasons the Commission should reject the Settlement.

RESPECTFULLY SUBMITTED this 18th day of June, 2013.

_____/s/_____
Daniel W. Pozefsky
Chief Counsel

[16] Assuming of course, that the SIB is approved in the Eastern case.

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 18th day
of June, 2013 with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

COPIES of the foregoing hand delivered/
Mailed this 18th day of June, 2013 to:

Sarah Harpring
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Janice Alward, Chief Counsel
Wesley Van Cleave
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Steven M. Olea, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Steven A. Hirsch
Stanley B. Lutz
Bryan Cave LLP
Two North Central Avenue, Suite 2200
Phoenix, AZ 85004

By _____/s/_____
Cheryl Fraulob